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CHARLES ELMORE CROPLEY

No. 142

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1945

AMERICAN SURETY COMPANY OF NEW YORK,
A CORPORATION,
Petitioner,

vs.

PAUL W. SAMPSELL, AS TRUSTEE IN BANKRUPTCY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR PETITIONER

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Opinions Below

The opinion of the District Court (R. 93) is reported at 53 F. Supp. 131 as *In re Stratton*. The opinion of the Circuit Court of Appeals (R. 126) is reported at 148 F. 2d 986.

Jurisdiction

The judgment of the Circuit Court of Appeals for the Ninth Circuit was entered on April 24, 1945 (R. 131). The petition for a writ of certiorari was filed June 21, 1945, and was granted on October 8, 1945 (R. 133). Jurisdiction of

this Court is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925 (c. 229, § 1, 43 Stat. 938; 28 U. S. C. § 347(a)) and under Section 24(c) of the Bankruptcy Act of July 1, 1898 (c. 541, 30 Stat. 553) as amended by the Act of June 22, 1938 (c. 575, § 1, 52 Stat. 854; 11 U. S. C. § 47(c)).

Question Presented

In the absence of any provision of federal law on the subject may a federal bankruptcy court, as a condition to allowing the general claim of a subrogated surety against a bankrupt principal, require the surety first to satisfy other general creditors who, prior to the bankruptcy proceedings, had failed to perfect and had therefore lost their potential claims against the surety under the state law pursuant to which the surety bond had been given and by which its coverage and operation were governed?

Statute Involved

The seventh paragraph of § 1183 of the Code of Civil Procedure of California (R. 89-90; hereinafter cited as C. C. P.) reads in part as follows:

> In case the surety or sureties on any bond given as in this chapter provided shall have caused said bond to be filed and recorded in the office of the county recorder of the county in which the property is situated, before the work of improvement is completed, then no action may be maintained thereon unless there shall previously have either been filed a mechanic's lien claim as in this chapter provided or unless written notice shall previously have been given to the surety on said bond before the expiration of the time prescribed in this chapter for filing a lien to enforce such claim . . .

Other relevant provisions of the California statutes are referred to in the argument, as are various provisions of the federal bankruptcy laws.

Statement

The facts, which are either stipulated (R. 85-92) or documentary, are as follows:

On January 2, 1941, Charles B. Stratton, the bankrupt, contracted with General Electric Company to make certain alterations in that company's factory building at Ontario, San Bernardino County, California (R. 87). On January 3, 1941, Stratton applied to petitioner, American Surety Company of New York, for a statutory laborers' and materialmen's bond (R. 85-86; see 58-67), which was executed in the sum of $33,950 (R. 86-88). On January 7, 1941, the plans and specifications, the construction contract, and the bond were filed and recorded in the office of the Recorder of San Bernardino County pursuant to § 1183 of the California Code of Civil Procedure (R. 88). On September 10, 1941, a notice of the completion of the work was similarly recorded (R. 89).

It is stipulated that on or about October 10, 1941, under California law (§ 1187, C. C. P.) the time expired for laborers and materialmen to file and record claims of lien (R. 89), which by another provision of California law is also the time limit for the permissible alternative notice to the surety (§ 1183, C. C. P.; R. 89). Five laborers and materialmen filed and recorded claims of lien and lodged timely written notices with the surety pursuant to the California statute (R. 90). Petitioner paid these in full in the total sum of $6,724.78 (R. 90-91).

On November 10, 1941, an involuntary bankruptcy petition was filed against Stratton (R. 2-8). On November 27, 1941, he was adjudged a bankrupt (R. 11).

The petitioner, as authorized by the Bankruptcy Act (11 U. S. C. § 93(i)), filed with the referee in bankruptcy its proof of claim for $6,987.48 (R. 52-56) based upon the indemnity agreement with Stratton (R. 63-65) and upon subrogation for the $6,724.78 in claims paid and $262.70 in expenses incurred (R. 29). The petitioner's entire claim was allowed as a general claim (R. 30, 36).

Among the general claims filed there appeared three others (R. 68-74, 75-81, 82-85) in the total sum of $1,336.11, based upon labor and materials furnished to Stratton in connection with the General Electric Company contract, for which no claim of lien had ever been recorded or notice to the surety given (R. 35-36, 91-92). These were allowed as general claims in bankruptcy (R. 36-37). Moreover, the referee in bankruptcy, admitting that these three claimants had "no cause of action which they could bring under law" against the surety, concluded that—because they were of the class of creditors for whose protection the bond had been written—the surety should receive no dividends from the estate upon its claim until these three had been paid in full (R. 37-38). He then ordered that, in addition to the dividends the three might receive upon their own claims, they should share pro rata in the dividend otherwise due the petitioner until they had been paid in full or the petitioner's dividend had been exhausted (R. 38). Thereafter any balance remaining of the petitioner's dividend might be paid to it (R. 38).

The petitioner then asked review of the referee's order (R. 41-48). Respondent Sampsell, as trustee for the bankrupt, secured an order requiring petitioner to show cause why the referee's decision should not be carried out (R. 48-51, 51-52). The District Court affirmed the referee (R. 93-99). The Circuit Court of Appeals for the Ninth Circuit concurred in that conclusion (R. 126-131).

Specification of Errors to Be Urged

The Circuit Court of Appeals erred:

1. In determining this controversy "without appropriate regard for rights acquired under rules of state law" through its refusal to recognize the California statute and decisions establishing the fact that on its surety bond petitioner has never been liable to certain other claimants to the bankrupt estate in whose favor petitioner's claim is subordinated by its decision.

2. In failing to give any effect to state law governing the substantive rights of claimants where a dispute arises between them in a bankruptcy proceeding.

3. In ordering the dividends on petitioner's allowed claim in bankruptcy to be paid to certain other creditors of the bankrupt to whom petitioner is not and has never been indebted.

4. In depriving the surety, contrary to equitable principles, of the usual bankruptcy rule of equality of distribution (Section 65(a), Bankruptcy Act) where the surety's claim is for subrogation after full payment of all valid claims of creditors under the statutory bond in this case although certain potential creditors of the surety were not paid solely because of their own lack of diligence in failing to perfect their rights as required by state statute in order to become actual creditors under the bond.

Summary of Argument

The question here is not whether the unpaid creditors are not proper general creditors, but whether they had or might be given a special status as secured creditors.

I. Under the law of California the rights of the three unpaid laborers and materialmen under the bond had never

been more than inchoate and even as such had been completely extinguished prior to the bankruptcy proceedings. The California statutes (1) state the basic lien liability of the owner of realty upon which improvements are made, (2) preserve other general remedies against the contractor who does the work, and (3) provide for both a limitation and partial substitution of the owner's liability through the procurement and filing of a contractor's bond such as here involved. Claims against the bond are not perfected until, within a specified period after the completion of the work, the filing of a claim of lien or the giving of notice to the surety. The courts of California permit no deviation from these requirements. Having failed to give the required notice or file a claim of lien, the unpaid laborers and materialmen lost any rights they might have perfected under the bond.

II. Federal law not only fails to authorize the revival and perfection of the lost claims under the bond but requires adherence to the state law by which those claims became extinct. The relevant state statutes are fully applicable here because (1) the bankruptcy laws contain or require nothing to the contrary, (2) the state law is therefore the rule of decision in the federal bankruptcy tribunal, and (3) there is no problem of equitable distribution because the claimants had no status as secured creditors.

ARGUMENT

The Circuit Court of Appeals (R. 129-130) held that:

> This is not an action on a bond, but is a bankruptcy proceeding. In this proceeding, the bankruptcy court was required to, and did, determine the relative rights of creditors—Campbell, Probert, Stevens, appellant and others—in the distribution of the bankrupt's estate. That determination was governed by Federal

law, not State law. We therefore have no occasion to consider the State court decisions cited by appellant.

Therein the court below failed to perceive that the question in issue was whether—under the state law which created the bond and governed the obligations thereunder—there was anything for the bankruptcy court to compose.

One other matter requires preliminary emphasis. There is no contention here that these unpaid laborers and materialmen do not have a claim for their services or supplies furnished. The California statute specifically preserves such rights (§ 1197, C. C. P.). That claim has been allowed in these proceedings as a general claim (R. 36-37). The question is whether they have an additional claim against the surety on a bond given to protect the owner of the realty from so-called mechanics' liens. If they have such additional claim, we may assume for sake of argument that they are entitled to payment by the surety before the surety may receive dividends from the bankrupt estate. If they have no such additional claim, they—like the subrogated surety—are entitled to participate in the proceeds of the bankrupt estate only as ordinary general creditors. The question here is, Did they have special rights under the bond or merely general claims for services and materials furnished?

I. Under the law of California the rights of the three unpaid laborers and materialmen under the bond had never been more than inchoate and even as such had been completely extinguished prior to the bankruptcy proceedings.

The rights here in issue are based on statutory liens on real property.[1] Provisions of the California Code of Civil

[1] The California Civil Code classifies liens as either "general or special" (§ 2873). Either is defined as "one which the holder thereof is entitled to enforce • • •" (§ 2874 and § 2875). But the Civil Code does not

Procedure (1) state the basic lien liability of the owner of realty upon which improvements are made, (2) preserve other general remedies against the contractor who does the work, and (3) provide for both a limitation and partial substitution of the owner's liability through the procurement and filing of certain bonds such as the one here involved. Thus the surety is substituted not for the contractor-bankrupt as the District Court seemed to assume (R. 97) but for the owner of the realty upon which the contractor was engaged to make improvements, and then only to the extent provided by the state law from which the laborers' and materialmen's lien or substituted bond springs. The following is an analysis of the state statutes:

(1) Laborers and materialmen "have a lien upon the property upon which they have bestowed labor or furnished materials, for the value of such labor done and materials furnished" (§ 1183, first ¶). If the property is not sufficient, personal judgment for deficiency may be obtained "in like manner and with like effect as in action for the foreclosure of mortgages" (§ 1194). Persons claiming the benefits of these provisions, "until thirty days after the completion of such work of improvement, as a whole, may file for record with the county recorder * * * a claim of lien" (§ 1187, first ¶) but, if the owner of the realty within ten days of the completion of the work fails to file with the county recorder a notice of completion, then the claim of lien may be filed within ninety days after the completion of the work (*id.*, third ¶). (In the case at bar the notice of

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create or define the lien. The California Code of Civil Procedure, in Part III entitled "Special Proceedings of a Civil Nature", contains in Title IV provisions respecting the so-called "Enforcement of Liens". Chapter I does no more than define a lien as "a charge imposed upon specific property, by which it is made security for the performance of an act" (§1180). Chapter II, with which this case is concerned, is entitled "Liens of Mechanics and Others upon Real Property".

completion was duly filed (R. 89), consequently the time for filing claim of lien was thirty days.) To enforce the lien so claimed, action must be brought within periods specified by statute after such filing (§ 1184a and § 1190).

(2) The contractor is nevertheless liable to the laborers or materialmen who have furnished services or materials (§ 1184c and § 1197). He is also required to defend actions brought against the owner of the realty, and with his bondsmen is liable to such owner for moneys the latter is required to expend upon lien claims (§ 1193).

(3) However, if the owner of the realty files his construction contract with the county recorder together with a bond for not less than half the contract price, conditioned for the payment of laborers and materialmen in any suit to foreclose the liens provided or in any suit upon the bond, then the liability of the owner is restricted to the amount due the contractor and the claimants must look to the contractor and his sureties on the bond for any excess (§ 1183, fourth and ninth ¶¶). If a contract and bond are so filed, the terms of the bond may limit actions upon it to six months from the completion of the work (*id.*, sixth ¶). If the contract and bond are so filed (*id.*, seventh ¶),

> then no action may be maintained thereon unless there shall previously have either been filed a mechanics' lien claim as in this chapter provided or unless written notice shall previously have been given to the surety on said bond before the expiration of the time prescribed in this chapter for filing a lien to enforce such claim * * *.

The nature of the notice in lieu of filing of a mechanics' lien is also prescribed (*id.*, eighth ¶). The time limit referred to is the 30-day period noted above (*id.*, first ¶).

It is manifest that the liens or rights substituted therefor are procedural devices to secure the payment of laborers

or materialmen. They are entirely creatures of statute, over and beyond the usual and preserved creditor rights of such persons (§ 1197). Certain steps are required to perfect the remedies so provided. Either a claim of lien or notice to a surety must be filed or given within prescribed time calculated from the date of the completion of the work. Even the statute of limitation measures from the time such lien is filed (§ 1190).

The bond.—It is stipulated that the bond is a form designated as "Laborers & Materialmen, Statutory Form for California" (R. 86). Except for names, dates, and amounts it is in the language of the statute.[2] That it does not cover more than the statute is the law of California. "The terms of the statute are read into the bond and control its interpretation and effect." *Carpenter* v. *National Surety Co.*, 25 Cal. App. 2d 90, 93, 76 P. 2d 523.

Construction.—The statutory provisions quoted or summarized above leave no room for construction, and the courts of California have found none. Either strict or substantial compliance with every term of the statute has frequently been enunciated as the only possible rule.[3] The

[2] The first paragraph states its coverage in the words of the fourth paragraph of § 1183, from which also is taken the language of the second sentence of the second paragraph of the bond relating to coverage. The concluding statement of a time limit for action upon the bond is taken from the sixth paragraph of the same section and expressly authorized thereby.

[3] The following is a fair summary of the California case law: "Mechanics liens are entirely of statutory creation, and the statute must be looked to both for the right to the lien and the mode by which it can be enforced. The right to a mechanic's lien depends upon compliance with the statute, and in order that a valid lien may arise and be enforced, the claimant must strictly, or at least substantially, observe and comply with the provisions of the statute, none of which may be regarded as unnecessary. It is unnecessary, however, to take any other step than is thus required. The mere furnishing of labor or material does not create a lien; but until the claim is perfected in compliance with the statute it is a mere inchoate personal right which the mechanic or materialman may perfect or not

necessity of filing a claim of lien is particularly insisted upon.[4] "In order, however, that the laborer or materialman may preserve and enforce his lien, he must file his claim therefor * * *" *Willamette etc. Co.* v. *College Co.*, 94 Cal. 229, 237, 29 P. 629. See the same effect *Weithoff* v. *Murray*, 76 Cal. 508, 18 P. 435; *Pacific Mut. L. I. Co.* v. *Fisher*, 106 Cal. 224, 39 P. 758; *Joost* v. *Sullivan*, 111 Cal. 286, 43 P. 896; *Hickman* v. *Freiermuth*, 21 Cal. App. 629, 132 P. 772, 773; *Pacific Mfg. Co.* v. *Rasmussen*, 42 Cal. App. 742, 746-747, 184 P. 54; *Norton* v. *Bedell Engineering Co.*, 88 Cal. App. 777, 264 P. 311. Without such compliance with the statutory requirements, the party has "merely a personal right to create a lien by complying with the statute"—a "mere personal, inchoate right to procure a lien". *Mills* v. *LaVerne Land Co.*, 97 Cal. 254, 257, 32 P. 169. To the extent that these decisions relate to claims against the owner of the realty rather than the similar filing or giving of notice respecting a substituted surety, they nevertheless state the policy of California with regard to the duties of laborers and materialmen under the same statutes and in connection with the same type of requirement. The filing of claims or notices in connection with bonds required of public improve-

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at his pleasure, and which, until perfected, has no tangible existence. A party desiring to hold and enforce a lien upon the property of one who did not employ him must bring his case clearly within the terms of the statute; and under the former provision that a contract not recorded should be void and labor and materials should be deemed to have been done and furnished at the personal instance of the owner, it was incumbent on a laborer desiring to preserve his lien to follow the provisions prescribed where labor had in fact been performed at the personal insistence of the owner." 17 Cal. Jur. § 50.

[4] The California case law on the point has been accurately summarized as follows: "While the lien of a mechanic or materialman is a constitutional right and attaches to the structure as the material is furnished or labor performed, it is not enforceable unless a claim of lien is filed within the specified period. The lien of a contractor under his contract is given solely by the statutory provisions in his behalf; no lien arises from the mere completion of the structure, but such completion must be followed by a claim of lien." 17 Cal. Jur. § 68.

ment contractors, under the same or parallel statutes, are as strictly construed. *A. L. Young Machinery Co.* v. *Cupps*, 213 Cal. 210, 2 P. 2d 321; *Republic Iron & Steel Co.* v. *Patillo*, 19 Cal. App. 316, 125 P. 923; *Smith* v. *McKnight*, 117 Cal. App. 427, 4 P. 2d 305. In any event, in the absence of California decisions to the contrary, the California statutes speak for themselves.

Here, it should be noted, the inchoate right to perfect what the statute had once offered was lost by the inaction of certain laborers and materialmen before the bankruptcy proceedings were initiated.[5] Consequently, if it could be revived and then perfected in the present proceedings, authority therefor must be found in the federal bankruptcy statutes—authority which the court below assumed and asserted but did not identify.

II. Federal law not only fails to authorize the revival and perfection of the lost claims under the bond but requires adherence to the state law by which those claims became extinct.

The relevant state statutes are fully applicable here because (1) the bankruptcy laws contain or require nothing to the contrary, (2) the state law is therefore the rule of decision in the federal tribunal, and (3) there is no problem of equitable distribution because the claimants had no rights whatever under the bond.

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[5] As stated heretofore in the Statement and text, the notice of completion of the work was filed September 10, 1941 (R. 89). Hence, under the California law (§ 1183) and as stipulated (R. 89), the time for filing a claim of lien or alternatively giving notice to the surety expired the following October 10. The bankruptcy proceedings were not commenced until the following November 19 (R. 2-8).

1. The federal Bankruptcy Act not only does not supersede the state law but, by clear implication at least, requires that the state law be followed.

The federal bankruptcy statutes, from which the federal bankruptcy courts receive their sole authority, do not supersede the state law here involved. The whole purpose of the bankruptcy law is to marshal and compose the assets, including "debts" (11 U. S. C. § 103), of the bankrupt for the benefit of creditors. The existence of these "debts" must naturally be determined under the law by which they are created or recognized except as the contrary may be expressly provided in the federal bankruptcy statutes. Assuming that it is within federal power to supersede state law in the respects here involved, Congress has not done so.

On the other hand, the bankruptcy statutes expressly recognize and provide for the operation of state laws. Thus, if the bankrupt in this case were a laborer or materialman under the very bond here involved, the following provision of the bankruptcy laws would apply (11 U. S. C. § 29(e); emphasis supplied):

> Where in any proceeding, judicial or otherwise, a period of limitation is fixed, either in such proceeding or by applicable Federal or State law, for taking any action, filing any claim or pleading, or doing any act, and *where in any such case such period had not expired at the date of the filing of the petition in bankruptcy*, the receiver or trustee of the bankrupt may, for the benefit of the estate, take any such action or do any such act, required of or permitted to the bankrupt, within a period of sixty days subsequent to the date of adjudication or within such further period as may be permitted by the agreement, or in the proceeding or by applicable Federal or State law, as the case may be.

This provision is the strongest possible recognition that state law prevails even in such a paramount matter as the preservation of the estate of the bankrupt.

Where a claim or lien might run against the bankrupt, the bankruptcy law also makes special provision which reads in part as follows (11 U. S. C. § 107(b), emphasis supplied):

> Statutory liens in favor of employees, contractors, mechanics, landlords, or other classes of persons * * * created or recognized by the laws of the United States or of any State * * * may be valid against the trustee * * * Where by such laws such liens are required to be perfected and arise but are not perfected before bankruptcy, they may nevertheless be valid, *if perfected within the time permitted by and in accordance with the requirements of such laws* * * *

Here, in connection with the same subject matter as is involved in the case at bar, is another express statutory provision recognizing the applicability of time limitations required by state law.

These provisions—one where the bankrupt asserts the claim, the other when a lien runs against him—exhaust the needs of the federal bankruptcy laws in the subject here involved. If in the present case inchoate and expired rights may be revived without compliance with state law, then they are preferred even above similar claims by or against the bankrupt. Sound statutory construction does not permit that such an irrational difference be engrafted upon the law.

2. Apart from the bankruptcy statutes, federal law supplies the rule of decision only where so required or provided—as is not the situation here.

No federal requirement is applicable to the situation here presented, nor is one required.[6] The otherwise applicable state statutes in no way interfere with the operations of federal bankruptcy courts. Hence, except that the forms and modes of proceeding are governed by federal law,[7] both by statute[8] and upon constitutional principle,[9] state law necessarily applies and governs. "The great body of law in this country which controls acquisition, transmission and transfer of property, and defines the rights of its owners in relation to the state or to private parties, is found

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[6] The rule requiring conformity with state law does not apply "where the Constitution, treaties, or statutes of the United States otherwise require or provide" (1 Stat. 73, 92; 28 U. S. C. § 725) or "in matters governed by the Federal Constitution or by Acts of Congress." *Erie R. Co.* v. *Tompkins*, 304 U. S. 64, 77, 78. Where the right or claim arises upon federal law, the remedial details required to be supplied by judicial implication require in each instance the fashioning of a rule which is "ultimately attributable to the Constitution, treaties or statutes of the United States, and does not owe its authority to the law-making agencies of" the state in which the matter is presented. *Board of Comm'rs* v. *United States*, 308 U. S. 343, 349-350; *Deitrick* v. *Greaney*, 309 U. S. 190, 200-201; *Helvering* v. *Leonard*, 310 U. S. 80, 85-86; *Fashion Guild* v. *Trade Comm'n*, 312 U. S. 457, 468; *Garrett* v. *Moore-McCormack Co.*, 317 U. S. 239, 245; *Baltimore & Ohio R. Co.* v. *Kepner*, 314 U. S. 44, 52; *United States* v. *Pink*, 315 U. S. 203, 230 *et seq.*; *United States* v. *Bethlehem Steel Corp.*, 315 U. S. 289, 299; *Sola Electric Co.* v. *Jefferson Co.*, 317 U. S. 173, 176-177; *Clearfield Trust Co.* v. *United States*, 318 U. S. 363, 366-367; *Anderson* v. *Abbott*, 321 U. S. 349, 365; *Note*, 54 Harv. L. Rev. 663, 665 n. 16.

[7] *Freeman* v. *Bee Machine Co.*, 319 U. S. 448, 452.

[8] The Rules of Decision Act, 28 U. S. C. § 725, provides that: "The laws of the several States, except where the Constitution, treaties, or statutes of the United States otherwise require or provide, shall be regarded as rules of decision in trials at common law, in the courts of the United States, in cases where they apply."

[9] *Erie R. Co.* v. *Tompkins*, 304 U. S. 64, 79-80. Here the state law involved is statutory, and hence even the doctrine of *Swift* v. *Tyson*, 16 Pet. 1, would govern and the state statutory requirements would prevail. *D'Oench, Duhme & Co.* v. *F. D. I. C.*, 315 U. S. 447, 465-467.

in the statutes and decisions of the state." *Davies Warehouse* v. *Bowles*, 321 U. S. 144, 155. This is so whether cases are pending in federal courts either because of the accident of diversity of citizenship [10] or because federal courts are the forum for other reasons.

Where the bankruptcy law deals with property rights regulated by state law, the federal courts in bankruptcy will follow the state courts even to the extent of permitting contractual or state liens to operate upon property after bankruptcy proceedings are begun. *Chicago Board of Trade* v. *Johnson*, 264 U. S. 1, 11, 15; *Security Mortgage Co.* v. *Powers*, 278 U. S. 149; *In re Wil-Low Cafeterias, Inc.*, 22 F. Supp. 522, 523. Conversely, rights to perfect liens or to perfect rights against substituted security, which have been extinguished or lost under state law, cannot be revived in bankruptcy proceedings. In *In re Willax*, 93 F. 2d 293, 295, the Circuit Court of Appeals for the Second Circuit said:

> There is nothing in the statute that enables the bankruptcy court to recognize a lien which the lienor has failed to continue in the way prescribed by the state law. Mechanics' liens are creatures of the law of the state where the real property is situated—in the present case New York—and that law governs the method whereby they may be continued as well as the mode of their creation. * * * Because the liens were not continued in any of the ways prescribed by the state law, they had lost all efficacy * * *

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[10] This Court has been careful to say, in requiring conformity with state law, that the cases, though brought in federal courts, are not there because the substance is created by federal law but because of the accident of diversity of citizenship. *West* v. *A. T. & T. Co.*, 311 U. S. 223, 231; *Stoner* v. *New York Life Ins. Co.*, 311 U. S. 464, 467; *Vandenbark* v. *Owens-Illinois Co.*, 311 U. S. 538, 540; *Klaxon Co.* v. *Stentor Co.*, 313 U. S. 487, 496; *Griffin* v. *McCoach*, 313 U. S. 498, 503.

Similarly in *Malott & Peterson* v. *Street*, 4 F. 2d 770, 772, the court below said:

> No doubt, the plaintiff in error might have filed a lien against the property * * * but it did not do so, and the time for filing such a lien had expired long before the adjudication in bankruptcy. * * * The plaintiff in error took none of the steps required by the statute to perfect its rights.

Thus the Circuit Court of Appeals, for the Ninth Circuit—which avows a contrary rule in the case at bar—properly insisted in the *Malott* case upon compliance with state law and rejected claims not perfected in accordance with the requirements of the California laborers' and materialmen's lien statutes.

While a court of bankruptcy has exclusive control over the administration of an estate in its possession, it may even submit to state courts particular controversies involving unsettled questions of state property law arising in the course of bankruptcy administration. *Thompson* v. *Magnolia Co.*, 309 U. S. 478, 483. The only state law which is superseded is the rules governing the method of liquidation of insolvent estates; but, even then, it must act with "appropriate regard for rights acquired under rules of state law". *Prudence Corp.* v. *Geist*, 316 U. S. 89, 95, 97. The question here is not the distribution to admittedly qualified claimants, but whether the claimants had under state law acquired any claim to the security substituted for the lien.

3. No problem respecting equitable distribution is presented, because the question is not one of allocation but whether the claimants had any rights.

It is an established rule in bankruptcy that a surety of an insolvent's obligation will not be permitted, either by taking

indemnity from his principal or by virtue of his right of subrogation, to compete with other creditors whose claims he has assured in whole or part but which had not been paid in full—because, to the extent that the surety thus participates in dividends from the bankrupt estate, he depletes the estate otherwise available to those secured and defeats the purpose of the suretyship. *Prudence Corp.* v. *Geist, supra,* p. 96; *American Surety Co.* v. *Electric Co.,* 296 U. S. 133. This rests upon the rule of the law of subrogation that a surety liable only for part of the debt does not become subrogated to collateral or to remedies available to the creditor unless he pays the whole debt or it is otherwise satisfied. *United States* v. *National Surety Co.,* 254 U. S. 73, 76. Nor may the same result be had by agreement for indemnity rather than subrogation. *Jenkins* v. *National Surety Co.,* 277 U. S. 258, 267.

However, that general rule has been applied only where the creditors so preferred have been effectively covered by the instrument of suretyship. The cases involve assured creditors whose claims not only have been covered but have been paid in part. The cases, and the principle, do not apply where the creditors are not or never were covered by the instrument of suretyship. For the reasons heretofore given, whether in the case at bar the three unpaid creditors had ever been covered by the bond of petitioner is a question of state law, which denies them the status of secured creditors. They might have been, but they failed or neglected to perfect that status. They are therefore nothing more than general creditors. The surety is expressly authorized to file its subrogated claim in federal bankruptcy proceedings (11 U. S. C. § 93(i)). It is therefore entitled as a general creditor to an equal per centum of the dividends paid out of the bankrupt estate to general creditors (11 U. S. C. § 105(a)). The bankruptcy court may not grant

a preference to some of them or grant some of them "what practically amounts to a lien" on the dividends payable to another general creditor. *Moise* v. *Scheibel*, 245 Fed. 546, 547 (C. C. A. 8). To permit the surety as a general creditor to stand in the shoes of the secured creditors whose claims it has actually paid does not prejudice the rights of other general creditors. *American Surety Co.* v. *Bethlehem Bank*, 314 U. S. 314, 318.

A further word may be said respecting the decision of this Court in *American Surety Co.* v. *Electric Co.*, *supra*, upon which the courts below relied. There, as in the other cases cited above, the creditors which were preferred were effectively covered by the suretyship instrument. No question of state law was presented, because the claim arose upon a federal building project, under a federal statute, and pursuant to a federal bond. There also the question did not involve subrogation to the bankrupt estate but claims to a fund set apart as collateral security, and the decision of the Court concedes that "the distinction might be important if the contest were between the surety and creditors not covered by the bond" (p. 138). The Court added that "slight differences in the facts may cause the equities to vary" and that the decision "must be kept within the bounds of the controversy" there involved (p. 139). That decision is wholly inapplicable here, because there the creditors were effectively secured. Here, by the operation of state law, they were not and indeed any rights they had to become secured had been extinguished prior to the bankruptcy proceedings.

Conclusion

The issue of this case is whether there shall be due recognition of the dignity and applicability of state statutes in causes which happen to be pending in federal tribunals. The federal Rules of Decision Act so requires. This Court

has been insistent that the law of the states, judicial as well as statutory, shall be accorded that effect. A breach in that policy will loose a flood of contention, in all manner of cases, that state law is superseded in one way or another.

For the reasons and upon the authorities stated, the judgment below should be reversed.

Respectfully submitted,

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